

Testimony of
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United States Securities and Exchange Commission
Before the Subcommittee on Oversight and Investigations,
Financial Services Committee
U.S. House of Representatives
Concerning Issues Raised by the Frank D. Gruttadauria Matter
May 23, 2002

Chairwoman Kelly, Ranking Member Gutierrez, and members of the Subcommittee:

I appreciate the opportunity to appear before the Subcommittee today on behalf of the Securities and Exchange Commission ("Commission") to discuss the Frank Gruttadauria matter, the system of regulation and oversight of broker-dealers, and potential measures to prevent future losses. As evidenced by the Commission's recent enforcement action, the Commission is extremely concerned about the alleged fraudulent activity by Gruttadauria and has taken action to address it. As the Subcommittee has requested, I will first provide you with an overview of the Commission's enforcement action against Gruttadauria.¹ I will discuss how broker-dealers are regulated, their own supervisory responsibilities over their registered representatives, and certain compliance practices they can follow to prevent the misappropriation of customer funds. Finally, I will describe some of the steps that investors can take to protect themselves against unscrupulous brokers.

I. SEC v. Frank Gruttadauria

On February 21, 2002, the Commission filed an action in Federal District Court² in Cleveland, Ohio against Gruttadauria alleging that he stole at least \$40 million from

¹ Testimony concerning Gruttadauria's conduct is confined to allegations contained in the Commission's complaint.

² SEC v. Frank D. Gruttadauria, et al. No. 1:02CV324, (N.D. Ohio, February 21, 2002).

more than fifty clients while employed as a registered representative with several broker-dealers.³ The Commission's complaint charges Gruttadauria with violating the anti-fraud provisions of the federal securities laws. On February 26, 2002, the Court entered a temporary restraining order against Gruttadauria and froze his assets. Then, on March 11, 2002, the Court granted a preliminary injunction against Gruttadauria and continued the freeze on his assets.

The Commission's complaint alleges that over a 15-year period Gruttadauria misappropriated customer funds for his own purposes, directing the funds to other customers' accounts either as purported returns or to satisfy withdrawal requests. He forged client signatures on withdrawals, made unauthorized transfers of funds, and took customer funds, purportedly to open accounts, but never actually opened those accounts.

According to the Commission's complaint, Gruttadauria was able to perpetrate this fraud, in part, by creating and sending false account statements to customers that greatly overstated the value of the customers' accounts. These statements also reflected holdings that did not exist and securities transactions that had never occurred. He also failed to disclose unauthorized withdrawals from the accounts. To further conceal his fraud, Gruttadauria then caused the clients' actual account statements to be sent to entities or post office boxes under his control.

The Commission's complaint also accuses Gruttadauria of materially misrepresenting the value of the positions held in customer accounts, often falsely telling customers that their accounts contained a wide variety of holdings worth millions of dollars. According to the Commission's complaint, the most recent false statements for the accounts of at least 50 of Gruttadauria's customers reflected an aggregate value of about \$278 million, whereas the actual value of accounts held for these customers at Lehman was about \$1.8 million.

The Commission's complaint also charges two entities controlled by Gruttadauria, DH Strategic Partners, Inc., and JYM Trading Trust, which the Commission alleges were used by Gruttadauria to misappropriate funds from his clients. The Commission's action names three relief defendants, Laurene English, Sarah Emamy, and Charlie Whiskey, LLC., alleging that they were unjustly enriched by Gruttadauria's fraudulent conduct. Specifically, the complaint alleges that Gruttadauria transferred funds, real property and automobiles to these relief defendants.

³ In December 1980, Gruttadauria became a registered representative with L.F. Rothschild & Co., Inc. In November 1987, Gruttadauria moved to Hambrecht & Quist, Inc. In May 1989, Gruttadauria joined the Cleveland, Ohio office of Cowen & Co. ("Cowen"), and in 1991, he became the manager of that office. In July 1998, Societe Generale purchased Cowen and changed the name from Cowen to SG Cowen Securities Corporation ("SG Cowen"). In October 2000, Lehman Brothers, Inc. ("Lehman") purchased the Private Client Group division of SG Cowen, which included the Cleveland office where Gruttadauria worked. According to Lehman, the group, which serviced high net worth clients, was comprised of 92 registered representatives and approximately 60,000 accounts.

The Commission's enforcement staff is continuing to investigate this matter, including whether any other persons or entities may have violated the federal securities laws.

II. The Regulatory Framework for Broker-Dealers

Self-regulation is the linchpin of the federal regulatory system for broker-dealers. At the most basic level, firms are responsible for their internal supervisory and compliance systems. Second, these efforts are supervised by the self-regulatory organizations ("SROs"). Finally, the Commission oversees the efforts of the firms as well as the SROs. In addition, the state securities regulators also regulate the activities of broker-dealers within their states. As a result of this system of self-regulation, the Commission is able to oversee a large and diverse population of broker-dealers with a small examination staff. At present, there are approximately 8,100 broker-dealers with 90,169 branch offices, employing 677,748 registered representatives. At the same time, the Commission deploys an examination staff of approximately 650, with 250 devoted to broker-dealer examinations.

A. The Duty to Supervise

A broker-dealer's "duty to supervise" is a key aspect of the federal securities regulatory scheme. Under SRO rules, broker-dealers have an obligation to establish a system of supervision reasonably designed to ensure that their employees' conduct complies with the federal securities laws and SRO rules. There is no single supervisory or compliance system appropriate for all broker-dealers. The rules of the various SROs, as well as the Securities Exchange Act of 1934 ("Exchange Act"), anticipate that each firm will develop its own system of supervision to promote effective compliance with the federal laws and SRO rules based on the nature of the firm's business.

Specifically, broker-dealers' supervisory structure, policies, and procedures must meet the requirements of SRO rules governing supervision, including NASD Rule 3010 and NYSE Rule 342. These rules generally require that SRO member firms establish, maintain, and enforce written procedures to supervise the activities of the firm and its registered personnel, and to prevent violations of various securities laws and rules. Broker-dealers are required to designate qualified personnel, including registered principals, to carry out the firm's supervisory obligations, to have adequate controls in place to identify weaknesses and sales practice abuses, and to conduct a review of firm activities on a periodic basis through the internal inspection of its various office locations. In addition, broker-dealers' compliance departments also serve an important function in helping to ensure that firm employees are in compliance with securities laws. They review exception reports, investigate indications of irregular activity, and investigate customer complaints.

The Commission is authorized to sanction firms whose supervision falls below a reasonable minimum. Specifically, Section 15(b)(4)(E) of the Exchange Act provides for the imposition of a sanction against a broker or dealer who has failed reasonably to

supervise, with a view to preventing violations of the securities laws and regulations, another person who commits such a violation and is, subject to their supervision. The Commission has emphasized that senior management must ensure that adequate procedures are in place, that sufficient resources are devoted to their implementation, and that supervisory responsibilities be reassessed in light of changes in a firm's business operations.

B. Self-Regulatory Organizations

The SROs act as front line regulators of their member broker-dealers. As such, they adopt rules with respect to the conduct of their member firms, conduct surveillance and periodic examinations of their members to evaluate compliance, and bring disciplinary actions when their rules are violated.⁴ The SROs examine every broker and dealer on a periodic cycle, varying from annually to once every four years, depending upon the type of firm and various risk factors.

C. The Commission's Oversight

The self-regulatory framework operates under the oversight of the Commission. While SROs have front line responsibility to oversee the conduct of their members, the Commission also regulates broker-dealers, conducts examinations of broker-dealers, and brings enforcement actions to enforce the federal securities laws and rules.

The Commission conducts three types of broker-dealer examinations: 1) oversight examinations; 2) cause examinations; and 3) surveillance examinations. Oversight examinations are conducted of firms that have been recently examined by an SRO, such as the NASD or NYSE, to evaluate the quality of the SRO's examination. Cause examinations are conducted when the Commission has a concern or an indication that a broker-dealer has engaged in or is engaging in violative activity. The focus of a cause exam is on those areas precipitating the examination. Surveillance exams focus on a particular practice or area.

In 1993, the Commission conducted a cause examination of the Chicago, Illinois office of Cowen, where Gruttadauria serviced some of his accounts, after receiving an anonymous oral complaint alleging churning in one of Gruttadauria's customer accounts. Based on this anonymous complaint, the Commission staff initiated an examination to review the account in which churning was alleged. While the examination noted significant trading in the customer's account, it appeared to be isolated to a few months in 1990, which was over three years prior to the examination. The account documents provided by the firm indicated that the customer was an experienced investor -- with an

⁴ During this period, the NYSE examined Cowen and noted a number of supervisory deficiencies. As a result, the NYSE brought a disciplinary action charging Cowen with failure to supervise by failing to implement adequate systems and procedures to ensure supervision. These actions resulted in a censure, a fine of \$380,000, and an undertaking to make a review of the firm's compliance system to determine the adequacy of the firm's systems and procedures.

estimated net worth of \$5 million, and ten years experience trading options and a greater number of years experience trading equities and commodities. According to the registrant and Gruttadauria, the trades in the customer's account were largely unsolicited, meaning they were directed by the customer and not recommended by Gruttadauria. The examiner also reviewed a number of Gruttadauria's other accounts maintained at this branch office, to assess whether any pattern of churning existed, but found no such pattern. In addition, the firm represented that the customer never complained about the handling of her account. Due to these factors, the examination was unable to establish any indications of sales practice abuse in connection with the account sufficient to warrant further action.

The Commission conducted other examinations of Cowen, though not at the Cleveland office where Gruttadauria was employed. In examinations in 1990, 1994 and 1997, Commission staff reviewed a sample of customer accounts and customer complaints, in part to detect any sales practice problems.⁵ These examinations resulted in deficiency letters.⁶ To our knowledge, none of Gruttadauria's customer's accounts were reviewed in these examinations.

III. Firm Practices That Can Serve to Detect and Prevent Misappropriation of Customer Funds or Securities

Many firms have in place procedures to help them prevent and detect theft by brokers. There are a variety of procedures firms are using to prevent theft by brokers, including the following:

- Verify Changes of Address With the Customer.
Firms verify any changes of address by sending notices of the change to both the customer's old and new addresses. Additionally, a supervisor or firm compliance employee telephones the customer to verify the change of address.
- Review Changes of Address and Changes to Customer Account Information.
Firms ensure that employees do not independently change customers' addresses and new account information without review by supervisors or compliance staff. Registered representatives do not have the ability to alter account statements on-line.
- Special Attention to P.O. Boxes and Addresses Other than Home Addresses.
Firms closely scrutinize customers' use of any address other than their home address. Use of P.O. boxes, "in care of" addresses, and other than home addresses are prohibited, or verified by telephone and in writing directly with

⁵ Commission staff also conducted discrete "cause examinations" of individual offices of Cowen for particular issues during this period, none of which involved the Cleveland office.

⁶ A deficiency letter is a non-public document that delineates the results from a staff examination. Deficiency letters are sent after more than two-thirds of the OCIE staff's examinations.

the customer by a supervisor or firm compliance employee.⁷ Duplicate confirmations and account statements are sent to the customer's home address, whenever possible.

- Confirm Customer Authorization to Transfer Funds.
All transfers, withdrawals, or wires from the customer's account are confirmed in writing to the customer. Additionally, a supervisor or firm compliance employee verifies the transfer or withdrawal (the amount and the recipient, including the account number the funds are to be transferred to, if applicable) directly with the customer by telephone, at least on a sample basis and for any unusual transfers or withdrawals. Because pre-signed letters of authorization do not provide adequate assurance of authorization from the customer, they are prohibited. Customer signatures are verified. Furthermore, firms have procedures for supervision of third party wire transfers and checks, and particularly scrutinize transfers to accounts serviced by the registered representative or branch manager.
- Review for Unusual Activity.
Firms focus on the possibility of abuse, and periodically and systematically review for indications of problems, such as: a registered representative that has a number of customers with non-home mailing addresses; any customer account that shows the same address as the registered representative; multiple changes of address by a customer or among customers of a registered representative; the use of the same address for multiple customers; or correspondence returned as undeliverable by the post office. Computer-generated exception reports are very effective in isolating indications of unusual activity.
- Investigate Unusual Activity.
Firms carefully investigate unusual activity. Firm compliance employees or supervisors contact the registered representative and contact the customer directly to follow up on and investigate unusual activity.
- Independent Supervision and Review of Activity by Producing Managers.
Firms have supervisory procedures in place to ensure that trading and other account activity in all managers' customer accounts is independently reviewed on a routine basis (by a firm employee who is not supervised by the manager and whose compensation is not controlled by the manager).
- Control Over Account Statements, Letterhead and Mail Facilities.
Firms maintain control over their account statements, letterhead and mail facilities to prevent unauthorized use. Firms use watermarks, distinctive

⁷ Some firms have obtained software from vendors that identifies non-home addresses, so that firms can carefully scrutinize these addresses and verify each address with the customer.

logos, holograms or colors that make duplicates of firm documents more detectable.

- Provide Customers with Account Information On-line.
Firms provide customers with access to their account statements on a secure firm website so that customers can easily verify activity in their accounts. Firms apprise customers that on-line access to their account information is available. Account statements also include the phone number of the registered representative's supervisor, in case of any questions or problems with the account.
- Supervise Employees' Use of Personal Electronic Devices.
Firms prohibit either employees' use of personal electronic devices (personal computers, blackberries) to conduct firm business or carefully monitor their use. Firms require that use of personal electronic devices be pre-approved and that they be linked with the firm's system to allow for supervisory review, or that data be periodically downloaded to the firm's system for review, or that a manager periodically review the contents of the electronic device.
- Firms Routinely Review Compliance with Policies and Procedures.
Compliance with policies and procedures designed to prevent theft by employees is reviewed regularly during the branch compliance audit, including during unannounced compliance audits. In addition, firms' internal audit staff periodically review controls in this area.

This case highlights the importance of firm procedures to prevent and detect theft by employees. Securities regulators are paying particular attention in all sales practice examinations to determine whether firms maintain adequate procedures to prevent theft.

IV. Investors Should Also Take Steps to Protect Themselves From Unscrupulous Brokers

While investors certainly do not bear responsibility for the fraudulent acts of others, investors can help to protect themselves. The Commission has an aggressive investor education program aimed at providing investors with information they may use to invest wisely. Investors can help to protect themselves by taking the following steps:

- Investigate Any Broker or Investment Adviser Before You Open an Account.
You can verify your broker's disciplinary history by obtaining information from the Central Registration Depository ("CRD"). Either your state securities regulator or NASD Regulation, Inc. ("NASDR") can provide you with CRD information. You can find out how to get in touch with your state securities regulator through the North American Securities Administrators Association, Inc.'s website, www.nasaa.org. To contact NASDR, visit its website, www.nasdr.com, or call them toll-free at (800) 289-9999. The SEC publishes a brochure for investors called *"Invest Wisely: Advice From Your*

Securities Industry Regulators.” It is available on the Commission’s website at www.sec.gov.

- Read and Understand the New Account Form.
Ask to see any account documentation prepared for you by the sales representative. Do not sign the new account form or margin agreement unless you understand it and agree to its conditions. Do not rely on any verbal representations from a sales representative unless they are contained in the agreement. Be careful about giving your sales representative “discretionary” authority to conduct transactions without your approval.
- Ask Questions.
Make sure that you understand the risks, costs, and fees associated with any investment. Understand how the sales representative is paid. A good broker or investment adviser will welcome your questions, no matter how basic. Financial professionals know that an educated client is an asset, not a liability. The Commission publishes a brochure for investors called “*Ask Questions: Questions You Should Ask About Your Investments... And What To Do If You Run Into Problems.*” It is available on the SEC’s website at www.sec.gov
- Read, Understand and Verify Account Statements.
Never allow your account statements to be delivered or mailed to your sales representative as a substitute for receiving them yourself. Read all of your account statements. Make sure that you understand all the activity in your account. Compare confirmations of account activity with routine account statements. You can verify your account statements by accessing your account information on the firm’s website, or by telephoning the firm’s main office. Monitor your investments’ value.
- Be Careful in Forwarding and Withdrawing Funds.
Never provide your broker with cash or a check made out to a sales representative; make checks payable to the brokerage firm or an investment fund. Never send checks to an address different from the business address of the brokerage firm or a designated address listed in the prospectus. Do not provide your sales associate with pre-signed authorizations to transfer or withdraw funds from your account. Any transfers or withdrawals should be authorized by you in writing at the time you wish to transfer or withdraw funds.
- Be Alert to Any Signs of Irregularity.
Be alert to irregularities including any unauthorized withdrawals or transfers, failing to receive confirmations or account statements, or delays in receiving funds withdrawn. Also, be wary of assurances from your sales representative that an error in your account is due solely to computer or clerical error. Insist that the branch manager or compliance officer promptly send you a written explanation. Verify that the problem has been corrected on your next account

statement. Other examples of irregular activity that you should be alert to are listed in the Commission's brochure "*Invest Wisely: Advice From Your Securities Regulator*," at www.sec.gov.

- Address Any Problems Promptly.

If you have a problem with your sales representative or your account, promptly talk with the sales representative's supervisor or a compliance manager. Confirm your complaint to the firm in writing, and ask for written explanations. If the problem is not resolved to your satisfaction, contact securities regulators and consider using arbitration to resolve your dispute.

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As we vigorously prosecute Gruttadauria for the fraud we allege he committed on his customers, securities regulators are taking action to prevent unscrupulous brokers from engaging in fraud and theft. We are promoting strong compliance practices by broker-dealers that are designed to prevent fraud and theft by their employees. Securities regulators are paying special attention in examinations to determine whether firms have adopted and maintain adequate supervisory and compliance procedures to prevent theft. Further, we must continue to educate investors about steps they can take to invest wisely.

Thank you for inviting me to participate in this hearing. I am pleased to answer any questions that the Subcommittee members may have.